Sample essay on finance

Business, Company

28th Februar, 2014

Financial Analysis

Answer 1)

Liquidity Analysis:

These ratios are used to judge short term solvency of a company i. e if it can honr its short term obligations. Generally two liquidity ratios are calculated:

i) Current Ratios = Current Assets/ Current Liabilities

ii) Quick Ratios= Current Assets- Inventory/ Current Liabilities

ii) Solvency Ratio:

These ratios are used to adjudge the long term solvency of the company i. e if the company can honor its long term obligations.

i) Debt to Equity Ratio: Debt/ Equity

ii) Interest Coverage Ratio: Operating Income/ Interest Expense

iii) Profitability Ratio:

One of the important ratios both for analysts and investors, as it helps them to know what profit margins are being earned by the company:

i)Net profit margins= Net Profit/ Sales*100

ii) Return on Equity: Net Income/ Total Equity

iv) Activity Ratios:

Also known as Asset Management Ratios, these ratios indicates the efficiency of the management to manage its assets.

Inventory Turnover Ratio= COGS/ Inventory

Commentary:

Our above analysis indicates that the Plastichem is going through tough financial time as all the ratio section provide a clear scenario. For Instance, both the liquidity ratios i. e current ratio and quick ratio indicates that the company is losing on its liquidity while DCM holdings has turned improved its liquidity position over a year.

Similarly, the profit margins of Plastichem has shown decreasing trend since 2001 and the company ended in loss during 2004. In contrast, DCM holdings has almost steady profit margins over the years. Most importantly, while Plastichem has negative ROE by the end of 2014, DCM holdings had been improving its ROE multiple since 2001 and this might attract more investors to the company.

In terms of solvency also, DCM holdings has maintained steady debt equity ratio which suggests that the company is not getting itself into much of the financial distress. On the other hand, negative equity holdings of Plastichem reveals high financial risk in the company.

Finally, Inventory Turnover Ratio was although better in Plastichem but was only marginally less than that of DCM holdings.

Answer 2)

Yes, Jay is right as common size analysis can turn out to be a useful tool when comparing two different companies irrespective of volume of numbers in the financial statements. A common size balance sheet express each balance sheet account as a percentage of total assets. Similarly, common size income statement express each income statement item as a percentage of total sales. Thus, common size analysis allows the analyst to easily compare the firm’s balance sheet and income statement even if the two firms follow different accounting standards.

Answer 3)

Du Pont analysis is an extended and advanced method to calculate Return on Equity. The Du-Pont equation divides the ROE multiple into three sections:

Return on Equity= Net Profit Margin* Asset Turnover*Equity Multiplyer

ROE= (Net Profit/ Revenue)* (Revenue/Assets)* (Assets/ Shareholder Equity)

i)Plastichem ROE= (-71. 7/297)* (2. 97/265. 6)* (265. 6/-14. 5)

=. 241* 0. 0111* -18. 31

= -5%

DCM Holding’s ROE= (7. 3/123. 6)*(123. 6/90. 1)*(90. 1/41. 1)=

= . 059* . 137* 2. 192= 17. 71%

The above analysis indicates that DCM holdings have high ROE in comparison to Plastichem. For Plastichem, the margins were already low which were further eroded by financial leverage. In contrast, 17. 71% ROE of DCM holdings were high but the major portion of the ROE was achieved through debt financing.

Answer 4)

Yes, the above three analysis do suffer from the following limitations:

Limitation of Ratio Analysis:

Financial Ratios are not used when used in isolation. They are only valid when compared to those of other firms or to the historical performance of the company.

Comparison with other companies is difficult when analyzing non-US firms.

Conclusions cannot be made from one set of ratios and all the ratios must be completed to come to a material conclusion.

Limitation of Dupont Equation:

One of the primary limitation of Dupont equation is that it do not consider the cost of capital and the results of Du-Pont Equation are not useful unless compared to ROE of other company.

Limitation of Common Size analysis:

Common Size Analysis suffers from the limitation that it fails to reflect the relative sizes of the companies under analysis.

Answer 5)

In his report, Jay must indicate the true financial condition of the company to Andrew. He may conclude his report that the company is not doing well in all the section and is losing on its profitability and liquidity to its competitor. Hence, soon it must try to improve its sales figures by launching new products or by working on untapped markets.

Answer 6)

Our analysis conducted suggest that the company is indeed going through tough financial times. In order to save the company, Andrew can only focus on plans to increase the sales numbers. In order to achieve higher sales volume, he must add new products and improve the existing one.

Answer 7)

The analysts ratings are significantly accurate as since DCM holdings is having good financial numbers it surely deserve a ‘’Buy Out’’ Rating. In contrast, deteriorating financial status of Plastichem lead to the rating of ‘’Hold’’